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Michael Powell, Chairman
Federal Communications Commission
445 Twelfth Street, S.W.
Room 8B-201
Washington, D.C. 20554

Dear Mr. Chairman:

AT&T has asked me to provide my advice on whether the Commission should seek further review of the D.C. Circuit's opinion in *USTA v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir. May 24, 2002), which remanded the Commission's *UNE Remand Order*, 15 FCC Rcd. 3696 (1999), and *Line Sharing Order*, 14 FCC Rcd. 20912 (1999). For the reasons explained below, I believe that the Commission should seek certiorari in this case. And while it is impossible to say with absolute certainty, I believe that if the Commission were to seek certiorari, it is highly likely that the Supreme Court would grant the petition and reverse the court of appeals' decision.

Clearly, the case is extremely important. The local telecommunications market remains perhaps the largest monopoly in the United States. In the Telecommunications Act of 1996 ("the Act") Congress "intended to eliminate the monopolies enjoyed by the inheritors of AT&T's local franchises" by using regulatory means to eliminate existing entry barriers. *Verizon Communications Inc. v. FCC*, Nos. 00-511 *et al.* (S. Ct. May 13, 2002). The principal regulatory mechanism adopted by the Congress in the Act to achieve this purpose was to allow "new entrants . . . to lease elements of the local telephone network from the incumbent monopolists" at cost-based rates. *Verizon*, slip op. at 2. In particular, Section 251(c)(3) of the Act requires an incumbent to unbundle those network facilities that the Commission designates pursuant to Section 251(d)(2), which directs the Commission to consider whether a competitor's ability to provide service would be "impaired" absent such access. In the *UNE Remand Order*, the Commission implemented this provision by adopting a "national" list of network elements that were required to be unbundled in all fifty states, finding that this would best serve the pro-competitive purposes of the Act. In *USTA v. FCC*, the court of appeals remanded the rules that the Commission adopted, finding the Commission had failed to justify adequately its conclusion that "broad" unbundling promotes the type of competition Congress intended in the Act.

1. At the outset, I would stress that certiorari of this opinion should be sought, among other reasons, in order to protect the Commission's institutional prerogatives. The *USTA* court paid mere lip service to *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984). No deference was accorded to the Commission's policy making expertise or its predictive judgments. To the contrary, as I explain in greater detail below, an extraordinarily stringent burden of proof was effectively placed on the agency to justify its policies. Although ostensibly framed as a conventional arbitrary and capricious review, the court of appeals effectively faulted the agency for failing to adopt the court's preferred policy outcomes.

2. Further, while it certainly remains the case that on remand the Commission could re-promulgate its existing rules if it supplied the explanations and evidence that the Court found lacking, as I explain in greater detail below, the *USTA* opinion enormously complicates that effort. This fact will not be lost on the market participants. Given that the incumbents have publicly argued that the decision means the Commission cannot on remand justify either the concept of a national list of unbundled network elements ("UNEs"), or the continued unbundling of particular network elements currently on that list, the resulting uncertainty makes it much more difficult for new entrants to develop business plans that rely on the availability of a particular network element in a particular location. In the wake of *USTA, moreover,* capital markets will be more reluctant to finance competitors that rely (either on whole or in part) on unbundled network elements to compete with incumbents. Given the seemingly daily reports of a new entrant local telephone competitor going bankrupt, this could irreparably harm the prospects for meaningful local competition in the near term.

There is no need for the Commission to let this state of affairs linger because I believe that the criticisms leveled at the *UNE Remand Order* in *USTA* are severely flawed, that these errors would be corrected by the Supreme Court on certiorari, and that the result would be a governing framework that provides greater long-term certainty, market stability, and investor confidence that the market-opening provisions of the Act can and will be implemented. Even if the Commission can reinstate the current rules on the present record under the court of appeals' decision, the decision will, unless reversed, impose standards to the agency will have to adhere in perpetuity, and apply even in different market conditions in which the decision would dictate different rules. Moreover, as I explain below, the *USTA* decision is logically flawed, inconsistent with numerous precedents, and is exceptionally vague on many central points. Any notion that the Commission could achieve needed market certainty by attempting to follow the directions provided in *USTA* and promptly issuing new rules is, therefore, illusory. The resulting decision would again be attacked from all sides, with the incumbents arguing that the Commission ignored *USTA*'s more extreme suggestions and with new entrants contending that the Commission acted within the (inappropriate) constraints of *USTA*, or improperly followed *USTA* rather than other, binding precedents.

3.a. Ultimately, I believe that the issues raised by *USTA* need to be resolved by the Supreme Court because *USTA* is inconsistent with the Supreme Court's earlier decision in *Verizon*, which found that the Commission had authority to set the rates for UNEs in order to promote local competition as broadly as possible. *Verizon*, slip op. at 17, 52, 68-69.[1] The Supreme Court's analysis is particularly germane to review of the *UNE Remand Order* because of the logical relationship between the price at which an incumbent can charge for an unbundled network element and the question whether the network element should be unbundled. "Low" prices do not help new entrants if the suite of network elements that can be leased is unduly limited.[2] Likewise, "broad" unbundling will not facilitate entry if incumbents are allowed to charge exorbitant prices.

The Supreme Court in *Verizon* found that the purpose of the Act was to "give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property." *Verizon*, slip op. at 17. The *USTA* decision, however, proceeded from a much different premise, finding that the Act was not intended to give competitors easy access to network elements. According to the panel, competition from new entrants that relies entirely on leasing UNEs is merely "synthetic" and, therefore, that there is no virtue to promoting access to UNEs as an end in itself. *USTA*, slip op. at 15.

In so disparaging UNE-based competition, the panel was clearly following Justice Breyer's *dissent* in *Verizon*.[3] Unlike the majority, Justice Breyer did not view the rapid introduction of competition through use of unbundled network elements as a positive good in itself. In Justice Breyer's view, the Act was not intended to facilitate such competition, but to require incumbents to share only those facilities where it would be "wasteful" to duplicate them. Indeed, Justice Breyer goes so far as saying that new entrants "do not compete in respect to the

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[1] In this regard, the Supreme Court has shown a ready willingness to review decisions involving the interpretation of core provisions of the Act. In *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 266 (1999), the Supreme Court reviewed both the Commission's authority to set rates for unbundled network elements as well as the precise issue raised here – the standard that the Commission must apply when implementing Sections 251(c)(3) and 251(d)(2). Likewise, in *Verizon Communications v. FCC*, *supra*, the Supreme Court granted certiorari from (and reversed) the Eighth Circuit's subsequent decision striking down the rules the Commission had promulgated to determine the prices that could be charged for leased elements.

[2] I mean "low" here in relationship to the levels that the incumbents would prefer to charge, not in any meaningful economic sense.

[3] I would note that in this regard that the panel does not actually cite Justice Breyer's dissenting opinion in *Verizon* but instead points to his concurring and dissenting opinion in *Iowa Utilities Board.* However, as explained below, the same propositions cited from Justice Breyer's *Iowa Utilities Board* opinion also appear in Justice Breyer's *Verizon* dissent and are expressly rejected by the *Verizon* majority. The fact that Justice Breyer was making the same analytical points in both opinions also underscores the logical relationship between the policies underlying the Commission's decision on what elements should be unbundled and its decision on what prices should be charged for those elements.

facilities that they share." *Verizon*, slip op. at 13 (Breyer, J. dissenting).[4] Thus, Justice Breyer, believes that "widespread sharing" of incumbent networks is inconsistent with the purpose of the statute. *Id.* Whatever the force of Justice Breyer's contentions, they were clearly rejected by the *Verizon* majority and *USTA*'s failure to so recognize is reversible error. The Supreme Court has already had this debate, and resolved it 7-1.

3.b. The *USTA* court inappropriately followed Justice Breyer's dissent, rather than the majority opinion in a second respect. The *USTA* court concluded that broad unbundling could in theory be supported to the extent that it promoted "facilities-based" competition (although not, as discussed above, "synthetic" competition based solely on UNEs). *USTA*, slip op. at 15-16. The court of appeals, however, found that the Commission could not justify its rules on this ground because it had not adequately addressed the incumbents' arguments that unbundling sapped the incentives of new entrants and incumbents to deploy facilities. Justice Breyer made exactly these points too in his dissent in *Verizon*, *see Verizon*, slip op. at 14 (Breyer, J., dissenting), but again, the majority of the Supreme Court expressly rejected Justice Breyer's views. The Supreme Court found both that the Commission's existing unbundling rules had promoted enormous investment in facilities by new entrants, *id* at 45-46, and that it was "commonsense" conclusion that "incumbents will continue to have incentive to invest and improve their services to hold on their existing customer base" in response to competition facilitated by the unbundling, *id.* at 46 n. 33.

3.c. Perhaps the starkest difference between *USTA* and *Verizon* is the level of scrutiny to which they subjected the Commission's predictive and policy judgments. The Supreme Court, following *Chevron* and its progeny, held that the "job of judges is to ask whether the Commission made choices reasonably within the pale of statutory possibility in deciding what and how items must be leased and the way to set rates for leasing them." *Verizon*, slip op. at 69. The court of appeals, on the other hand, repeatedly placed an uncharacteristically demanding burden of proof on the Commission to validate its exercise of discretion. It is a firmly established principle of administrative law that courts are required to defer to predicative judgments of an agency that are within its core expertise, and that principle, which governed *Verizon*, was repeatedly flouted in *USTA*.

4. The preceding analysis demonstrates that the *USTA* decision is inconsistent in several important respects with *Verizon* and, for that reason, a petition for certiorari by the Commission is likely to be granted and the *USTA* decision is likely to be reversed. But I also believe that the *USTA* opinion is fundamentally flawed for a different, independent reason. While recognizing that a new entrant would be impaired without access to a UNE if the costs of self-deploying the facility itself were significantly above the incumbents' costs, language in the opinion – although

[4] Although perhaps literally true, this claim does not mean, as Justice Breyer suggests, that a new entrants that leases all its network capabilities from the incumbent does not compete with the incumbent. Such a carrier would, in fact, compete with the incumbent with regard to retail and marketing efforts. To the extent new entrants could offer at retail services different than those offered by the incumbent, or the same types of services offered by the incumbent but at lower prices, this clearly benefits consumers.

subject to varying interpretations – potentially suggests a very cramped view of the types of costs that can be legitimately considered by the Commission.

In particular, while dismissing (correctly) the incumbents' argument that a new entrant is only "impaired" when the facility is an "essential facility" under antitrust laws, *USTA* goes on arguably to imply that the principal cost difference that should be considered is whether the facility has natural monopoly characteristics. *USTA*, slip op. at 18-20.[5] The panel reasoned that any other approach would impermissibly allow the Commission to find "impairment" based on "universal" cost disparities that exist "between new entrants and incumbents in any industry." *USTA*, slip op. at 20.

This requirement is fabricated out of whole cloth. There certainly is no basis in the text of the Act to limit "impairment" in this artificial manner. It also makes no sense. The statute was designed to open these particular markets to competition in the face of historic monopolies and directed the Commission to consider any "impairment" that would inhibit new entrant competitors' ability to offer service. It makes no difference to achievement of that statutory goal whether the impairments are of the sort shared by new entrants in other industries or not.

And while the panel cited *Verizon* to support this notion, if anything, *Verizon* forecloses the idea that only "natural monopoly"-related entry barriers are relevant to assessing impairment. *Verizon* states that entrants may need access to incumbent facilities merely because those facilities are "very expensive to duplicate," *Verizon*, slip op. at 38 n.27 – not just facilities that are economically infeasible to duplicate. Further, the Supreme Court found that the Commission could reasonably make that assessment from the perspective not of a "large competitive carrier such as AT&T or WorldCom" with substantial "resources" but from the perspective of "the hundreds of smaller entrants . . . seeking to gain toeholds in local-exchange markets." *Id.*[6]

[5] I would note that the panel's decision on these points is contradictory. Those facilities that have strong natural monopoly characteristics are typically the type of facilities that are considered "essential" under the antitrust laws. *See, e.g., MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1132-33 (7th Cir. 1983) (local phone networks); *Consolidated Gas Co. of Fla. v. City Gas Co. of Fla.*, 665 F. Supp. 1493 (S.D. Fla. 1987), *aff'd*, 880 F.2d 297 (11th Cir. 1989), *on rehearing*, 912 F.2d 1262 (11th Cir. 1990) (gas pipeline), *vacated and dismissed on other grounds*, 499 U.S. 915 (1991). *See also Fishman v. Estate of Wirtz*, 807 F.2d 520, 574 (7th Cir. 1986) (Easterbrook, J., dissenting in part) ("All of the essential facility cases involve natural monopolies.") Thus, to the extent the panel might be construed to be saying that only natural monopoly facilities should be unbundled, it is effectively imposing an essential facilities doctrine.

[6] I would also note that elsewhere the D.C. Circuit has recognized that there is considerable economic support for the notion that even costs that are equally "borne by all participants" in the market can be considered legitimate entry barriers. *See* United *States v. Microsoft Corp.*, 253 F.3d 34, 56 (D.C. Cir. 2001) (citing 2A Areeda & Hovenkamp, ANTITRUST LAW § 420c, at 61; Joe S. Bain, BARRIERS TO NEW COMPETITION: THEIR CHARACTER AND CONSEQUENCE IN MANUFACTURING INDUSTRIES 6-7 (1956)).

An exclusive focus on whether or not a facility enjoys substantial scale economies also ignores other real obstacles that prevent new entrants from deploying their own facilities in competition with incumbents. Any economically reasonable assessment of impairment must account for the fact that an incumbent telephone carrier will have already sunk its costs while a new entrants will not have. *See First Video Competition Report*, 9 FCC Rcd. 7442, ¶ 40 (1994) ("expenditures [that] are unrecoverable by the entrant in the event of market exit and may constitute . . . a sunk cost impediment to entry."). Having sunk its costs, the incumbent can drop its retail prices in response to competitive inroads at any time down to marginal costs. Also, because incumbent telephone providers typically enjoys significant economies of scale, an incumbent's marginal costs are low. Conversely, prior to entry, all the investments a carrier would need to make to provide service are marginal. Further, the majority of the investments necessary for entry must be sunk and, therefore, would be stranded if the new entrant is ultimately forced to exit. Knowing this, a carrier will not enter if it believes that there is a likelihood that the incumbent will reduce prices to a level that makes competition unsustainable.

But even if I am wrong and it is the case that the sunk cost problem is minimal, new entrants still face the existence of a "first mover" entry barrier. Here, I am using the term "entry barrier" in its technical sense. An entry barrier is "a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry." George J. Stigler, THE ORGANIZATION OF INDUSTRY 67 (1968); *see also Bell Atlantic-NYNEX Merger Order*, 12 FCC Rcd. 19985, ¶ 129 n.247 (1997) (same). In other words, an entry barrier exists when the new entrant must incur a cost at or after entry that the incumbent did not have to occur when it entered. When such entry barriers exist, new entrants must charge higher prices than incumbents to recover their costs.

Here, there are many instances where, because the incumbents were the first to enter the market, new entrants must incur much higher costs to provide service than the incumbents. By virtue of their franchise monopolies, incumbent telephone carriers received rights of way from local governments for underground cables and telephone poles and wires with only minimal transaction costs, for persons in the neighborhood or municipality otherwise would not receive *any* telecommunications services. Similarly, building owners and landlords understandably welcomed and accommodated the incumbents that promised to bring, for the first time, telecommunications facilities to a building. In contrast, new entrants meet substantial resistance from municipalities and landlords when seeking to gain comparable rights-of-way. In many cases, these entities do not view the ability of consumers to chose among competing carriers as providing significant value and are reluctant to have streets dug up (in the case of municipalities) or have to grant additional parties access to common space (in the case of building owners).

Further, whereas incumbents entered markets with no competitors and today, as a result, have facilities in place to serve all customers, new entrants must often deploy facilities based on projections or speculation that there will be demand for such facilities. And "new entrants must entice customers with a lower price and/or incur a greater selling expense per unit than the incumbent(s). As a result, . . . an entrant must incur promotional expenditures to overcome the incumbent's existing market dominance." *See First Video Competition Report*, 9 FCC Rcd. 7442, ¶ 40 (1994). Finally, because of the disadvantages new entrants face in competing with incumbents and the sunk nature of local facilities investment, investors will view deployment of local facilities by new entrants as much riskier than the deployment of local facilities by incumbents and, therefore, new entrants will have a higher cost of capital than incumbents.

5. I recognize that an interpretation of the decision that precludes consideration of these factors is not the only possible interpretation. But incumbents will undoubtedly argue for such an interpretation, and the fact that such basic points could even be the subject of debate underscores the uncertainty and adverse competitive effects that will be fostered if this decision is left as the final appellate statement of how the unbundling regime should be implemented. Both the long-term national interest in establishing competitive telecommunications markets, and the Commission's institutional interest in defending its prerogatives, counsel strongly in favor of seeking further review. I am confident that efforts to obtain such a review, and a reversal of the decision, would likely be successful.

Sincerely,

Robert H. Bork

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RHB:lh
cc: Commissioner Abernathy
Commissioner Copps
Commissioner Martin